

Estimating Trademark Royalty Rates for Intercompany Transfer Price Analyses

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A version of this discussion was originally published in World Trademark Review, Issue 71. Transfer price analysts (“analysts”) are often called on to estimate arm’s-length trademark royalty rates as part of a tax-related intercompany transfer price analysis. This discussion (1) summarizes the regulations for transfer pricing for federal income tax purposes and (2) describes the intangible property intercompany transfer price methods that may be used to evaluate whether or not transactions between members of controlled groups satisfy the arm’s-length standard. This discussion then provides insight regarding the factors to consider when estimating trademark royalty rates for intercompany transfer price analyses, with a focus on comparability factors for selecting market-based transactional data.

INTRODUCTION

In recent years, the Internal Revenue Service (the “Service”) has increased its scrutiny of many intangible property transfer price arrangements. This is because the Service is concerned that a domestic taxpayer could avoid domestic taxes by transferring intangible property, and allocating the associated income, to a related foreign entity located in a country with a lower income tax rate.

A significant portion of the commercial taxpayer income may be associated with its intangible property. Accordingly, the intercompany transfer of this intangible property may have a material effect on the domestic income taxes incurred.

In the recent *Amazon.com* decision, the Service contended that the reported buy-in payment of \$254.4 million for the controlled transfer of intangible property (including trademarks, trade names, and domain names, as well as software and other technology and customer lists) had not been determined at arm’s length.¹

The Service then determined a buy-in payment of \$3.6 billion, which the Tax Court found to be unreasonable.

The *Amazon.com* decision indicates the increased scrutiny of intangible property trans-

fer price arrangements by the Service. And, the *Amazon.com* decision provides insight into the estimation of intercompany transfer price trademark royalty rates. This discussion makes frequent reference to guidance from the *Amazon.com* decision.

This discussion focuses on the intercompany transfer of intangible property—and specifically trademarks, trade names, and brand names (referred to collectively in this discussion as “trademarks”)—between international subsidiaries of a multinational parent corporation.

Trademarks are valuable intangible property that are frequently transferred or licensed from one related entity to another related entity. Trademark royalty rates are typically one of the most hotly contested aspects involved in an intangible property transfer pricing dispute.

For U.S. income tax purposes, related-party transactions are regulated by the Service according to Internal Revenue Code Section 482 and the associated Treasury Regulations. This discussion focuses on the best practices described in the Section 482 regulations. The trademark royalty rate estimation methodology presented in this discussion may also be applicable to trademark transfer price analyses or valuations performed for other purposes.

To develop supportable transfer pricing trademark royalty rates, transfer price analysts should:

1. have a clear understanding of the Section 482 regulations and the general factors and circumstances that affect the pricing of trademark royalty rates and
2. prepare a defensible analysis that considers the best method rule, relevant comparability criteria, and reliable market-based transactional data.

First, this discussion provides an overview of the Section 482 regulations pertaining to trademark transfer pricing. Second, this discussion presents the methods and procedures to estimate trademark royalty rates and the factors and circumstances to consider when selecting trademark royalty rates for transfer pricing purposes.

OVERVIEW OF THE SECTION 482 REGULATIONS AND THE ARM'S-LENGTH STANDARD

Analysts should develop a thorough understanding of the Section 482 regulations when estimating a trademark royalty rate as part of an intercompany transfer pricing engagement for federal income tax purposes.

The purpose of the Section 482 regulations is to ensure that taxpayers clearly reflect the income attributable to controlled transactions. The Section 482 regulations place controlled taxpayers on parity with uncontrolled taxpayers.

For purposes of the Section 482 regulations, “taxpayers” includes any one of two or more persons, organizations, trades, or businesses that is not owned or controlled directly or indirectly by the same interests.

The standard to be applied under the Section 482 regulations is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's-length standard if the results of the controlled transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same or comparable transaction under the same or comparable circumstances.

The definition of controlled “includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.”²

The U.S. Tax Court and transfer pricing practitioners often equate the arm's-length price of a property to the fair market value of the property at the time of a transaction.

The arm's-length price of intangible property should be commensurate with the income attributable to the intangible property. If the intangible property transferee pays nominal or no consideration for the intangible property at the transaction date and the transferor retains a substantial interest in the property, then the arm's-length consideration may be in the form of royalty payments.

If intangible property is transferred through an arrangement that covers multiple years, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible property.

The Section 482 regulations discuss guidelines for comparing the subject controlled transaction to similar uncontrolled transactions. This comparative analysis requires the examination of the facts and circumstances relevant to (1) the controlled transaction and (2) the uncontrolled transactions used to test the arm's-length result of the controlled transaction.

INTANGIBLE PROPERTY TRANSFER PRICE METHODS

There are four intangible property intercompany transfer price methods discussed in the Section 482 regulations:

1. The comparable uncontrolled transaction (“CUT”) method
2. The comparable profits method
3. The profit split method
4. Unspecified methods

These transfer price methods may be used to evaluate whether or not the transfer of intangible property between members of a controlled group satisfies the arm's-length standard. If the transfers are found to not meet the arm's-length standard, these transfer price methods may be used to estimate an intercompany transfer price arrangement that does comply with the arm's-length standard.

Comparable Uncontrolled Transaction Method

Analysts may use the CUT method to evaluate whether the amount charged for a controlled transfer of intangible property meets the arm's-length

standard by reference to the amount charged in a comparable uncontrolled transaction.

The CUT method “compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction.”³

The Section 482 regulations allow for application of the CUT method both where the comparable transaction involves the same intangible property under substantially the same circumstances as the controlled transfer and, absent such evidence, when the comparable transactions involve comparable intangible property under comparable circumstances.

Circumstances are considered comparable if:

1. there are at most only minor differences between the controlled and uncontrolled transactions,
2. the differences have a definite and reasonably ascertainable effect on the amount charged, and
3. appropriate adjustments are made to account for any differences.

The intangible property transferred in an uncontrolled transaction is generally considered to be comparable to that transferred in the controlled transaction if both intangible properties:

1. are used in connection with similar products or processes within the same general industry or market and
2. have similar profit potential.

It is noteworthy that controlled transactions and comparable uncontrolled transactions do not have to be identical. With regard to the standard of comparability, the Section 482 regulations indicate that controlled transactions and comparable uncontrolled transactions need only be “sufficiently similar” to indicate a reliable result. Comparability of controlled and uncontrolled transactions will be further analyzed in a later section of this discussion.

In the *Amazon.com* decision, the expert witnesses for both the respondent and the petitioner employed the CUT method to value the subject marketing intangible property. The Tax Court affirmed that the CUT method was appropriate for that particular analysis.

Comparable Profits Method

The comparable profits method evaluates whether the amount charged in a controlled transaction is at arm’s length based on objective measures of

profitability derived from uncontrolled entities (i.e., persons, organizations, or businesses) that engage in similar business activities under similar circumstances.

Profit Split Method

The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to a controlled transaction meets the arm’s-length standard by reference to the relative value of each party’s contribution to the combined profit or loss of both parties.

The combined operating profit or loss should be derived from the most narrowly identifiable business activity of the controlled entity.

Unspecified Method

An unspecified method may be used to determine whether a controlled transaction meets the arm’s-length standard by indicating the prices or profits that the controlled party could have realized by choosing a realistic alternative to the controlled transaction.

An unspecified method should take into account the general principle that the parties of an uncontrolled transaction typically evaluate the terms of a transaction based on consideration of the realistic alternatives to that transaction. The parties of an uncontrolled transaction typically will only enter into a particular transaction if there are no better alternatives.

It is noteworthy that to the extent that an unspecified method relies on internal data rather than on uncontrolled comparable data, its reliability is reduced.

Best Method Rule

The Section 482 regulations require that arm’s-length considerations for intercompany transactions be determined using the best method rule.

The best method rule states, “The arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result. . . . There is no strict priority of methods, and no method will invariably be considered to be more reliable than others.”⁴

Analysts should select the method that relies on the most comparable data available based on the results of transactions between unrelated parties. If comparable market transactional data are available, the CUT method may be the most relevant method for trademark transfer price analyses. In many

cases, comparable trademark license transactions (i.e., market-based transactional data) provide the most defensible and reliable evidence of an arm's-length result.

For example, the Tax Court indicated in the *Amazon.com* decision, "If an uncontrolled transaction involves transfer of the same intangible under the same or substantially similar circumstances, the CUT method will generally yield the most reliable measure of the arm's-length result. If uncontrolled transactions involving the same intangible under the same or substantially similar circumstances cannot be identified, uncontrolled transactions involving 'comparable intangibles under comparable circumstances' may be used, but the results may be less reliable."⁵

The two primary factors to consider when determining which of two or more available methods provides the most reliable indication of an arm's-length result are as follows:

1. The quality of the data and assumptions used in the analysis
2. The degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions.

The following factors are particularly relevant in evaluating the quality of the data and the assumptions used in the analysis:

1. Completeness and accuracy of the data
2. Reliability of assumptions
3. Sensitivity of the results to deficiencies in data and assumptions

COMPARABILITY OF CONTROLLED TRANSACTIONS AND UNCONTROLLED TRANSACTIONS

The Section 482 regulations specify general factors to determine the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions including the following:

- Functions performed—Analysts should perform an in-depth comparative analysis of the economically significant activities undertaken by the entities in the controlled and uncontrolled transactions. Functions analyzed may include the following:
 1. Research and development
 2. Product design and engineering
 3. Manufacturing, production, and process engineering

4. Marketing and distribution
5. Other relevant functions

- Contractual terms—An analysis of contractual terms may include the following:
 1. The form of consideration paid
 2. Sales or purchase volume
 3. Duration of the license
 4. Collateral transactions or ongoing business relationships between the parties
 5. Extension of credit and payment terms
- Risks assumed—Comparability with regard to risks assumed requires consideration of risks that may affect prices charged or profits earned. This analysis may consider risks associated with the following:
 1. Market fluctuations in cost, demand, and pricing
 2. The success or failure of research and development activities
 3. Financial risks such as interest rates, foreign currency exchange rates, and credit and collection risks
 4. Product liability risks
 5. Other general business risks
- Economic conditions—A comparative analysis of the economic conditions affecting the controlled transaction and any uncontrolled transactions may include factors such as the following:
 1. The geographic markets served
 2. The size and economic development of markets
 3. The level of market (i.e., wholesale, retail, etc.)
 4. Market share
 5. Competition
- Nature of the property or services—Analysts should perform a comparative analysis with regard to the property or services of the controlled and uncontrolled transactions.

Analysts may make adjustments to transactional data in any method in order to increase the comparability between the controlled transaction or taxpayer and the uncontrolled comparable transactions. Adjustments may be made based on commercial practices, economic principles, or statistical analyses. However, the number, magnitude, and reliability of adjustments to transactional data may affect the reliability of the results of the analysis.

For purposes of the Section 482 regulations, “In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm’s length result.”⁶ In other words, inexact comparable transactions may be used to estimate an arm’s-length result.

The above comparability factors are useful to identify relevant market-based transactional data and select the most appropriate intangible property transfer price method. Based on the availability of market-based transactional data, the CUT method is often selected as the best method for trademark transfer price analyses.

Therefore, the remainder of this discussion focuses on the factors and circumstances to consider when selecting a trademark royalty rate for transfer pricing purposes.

DEFINING THE SUBJECT INTANGIBLE PROPERTY

An initial procedure in estimating trademark royalty rates using the CUT method is the identification of the property subject to analysis. Determining the analysis subject is an important procedure in any tax-related transfer price analysis, and it is especially important when using the CUT method. This is because the credibility of the CUT method is based on identifying comparable transactions involving comparable property.

For purposes of the Section 482 regulations, intangible property is considered to be property that includes any of the following items:

1. Patents, inventions, formulas, processes, designs, patterns, or know-how
2. Copyrights and literary, musical, or artistic compositions
3. Trademarks, trade names, or brand names
4. Franchises, licenses, or contracts
5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data
6. Other items similar to the above items that derive value not from physical attributes but from intellectual content or other intangible properties

The above-listed intangible property can be transferred as a single asset or as a bundle of assets. It is important for analysts to identify exactly what bundle of property was transferred and what bundle of property is being analyzed.

With regard to the identification of intangible property, we note that the transferred intangible property is not equivalent to the business enterprise into which the intangible property were transferred. In the recent *Amazon.com* decision, an expert witness for the Service estimated the value of the transferred intangible property by capitalizing the cash flow from the entire business enterprise into which the intangible property were transferred.

The Tax Court rejected this analysis, stating that it “in effect treated the transfer of pre-existing intangibles as economically equivalent to the sale of an entire business. . . . By employing an enterprise valuation, [the expert witness] necessarily sweeps into his calculation assets that were not transferred under the [cost sharing arrangement] and assets that were not compensable ‘intangibles’ to begin with. . . . These include workforce in place, going concern value, goodwill, and what trial witnesses described as ‘growth options’ and corporate ‘resources’ or ‘opportunities.’”⁷

OTHER CONSIDERATIONS IN THE ANALYSIS OF TRADEMARK ROYALTY RATES

There are numerous additional attributes that may affect the estimation of trademark royalty rates. These additional attributes include the following:

1. Age of the trademark (both absolute and relative to the trademarks of competitors)
2. Consistent use of the trademark
3. Specificity of use of trademark (i.e., whether the trademark is applicable to a wide range of products)
4. Geographic limitations of trademark recognition
5. Potential for expansion and exploitation of trademark
6. Association with positive events, persons, or locations
7. Timeliness of trademark (i.e., whether the trademark is perceived as modern)

Some of the economic attributes may be more relevant to one trademark than another. However, these attributes can help the analyst perform an overall assessment of the quality and nature of the trademarks when conducting a pricing analysis. This assessment may assist the analyst in:

1. understanding the use and function of the trademarks and

2. identifying the factors (and, ultimately, the methods and procedures) that are important in the pricing of the trademarks.

SOURCES OF TRADEMARK LICENSE AGREEMENTS

Analysts may use a number of data sources in order to identify comparable trademark license agreements. These data sources include government databases, news and industry trade publications, and third-party subscription-based royalty rate databases.

Examples of third-party intangible property license agreement royalty rate databases include the following:

1. RoyaltySource (www.royaltysource.com)—This AUS Consultants database provides intangible property license royalty rates and sale data. RoyaltySource provides access to source documents.
2. RoyaltyStat, LLC (www.royaltystat.com)—RoyaltyStat is a subscription-based database of intangible property license royalty rates, license agreements, and sale data compiled from Securities and Exchange Commission (“SEC”) documents.
3. RoyaltyRange (www.royaltyrange.com)—RoyaltyRange provides online access to license royalty rate and other license information related to technology, patents, trade secrets, and other intangible property.
4. ktMINE (www.bvmarketdata.com)—ktMINE is an interactive database that provides direct access to intangible property license royalty rates, license agreements, and sale agreements. Source documents may be printed.

These third-party royalty rate data providers collect transactional data regarding intangible property (including trademark) license agreements from publicly available sources, such as SEC filings, news articles, industry trade publications, and company press releases.

Selecting Comparable Transactions

This discussion previously presented comparability criteria to assist the analyst in identifying which intangible property transfer price method is most supported by available market-based transactional data under the best method rule.

The aforementioned comparability criteria may be used to identify CUTs in the CUT method. And, the Section 482 regulations discuss further comparability considerations specifically with regard to the selection of CUTs.

When selecting comparable trademark license transactions for a transfer pricing analysis, all of the relevant factors that affect the price that would be paid or the profit that would be earned in the transactions should be considered.

In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangible properties should:

1. be used in connection with similar products or processes in the same general industry or market and
2. have similar profit potential.

The Section 482 regulations state that factors that may be relevant in assessing the comparability between the controlled and uncontrolled transactions include the following:

1. The terms of the transfer (including exclusivity characteristics, limitations on use, and the geographical area in which the rights may be exploited)
2. The stage of development of the intangible property
3. The rights to receive updates, revisions, or modifications of the intangible property
4. The uniqueness of the intangible property
5. The duration of the license, contract, or agreement, and any termination or renegotiation rights
6. The economic and product liability risks to be assumed by the transferee
7. The existence of any collateral transactions or ongoing business relationships between the transferee and the transferor
8. The functions to be performed by the transferor and the transferee

Additionally, the comparison between controlled transactions and uncontrolled transactions should typically be performed over a similar time period. Similarity of the controlled transactions to comparable uncontrolled transactions in one period does not indicate that this similarity holds in other periods.

To select supportable comparable trademark royalty rates, analysts should prepare a thorough

“Analysts should estimate inter-company transfer price trademark royalty rates using guidance from the Section 482 regulations.”

and well documented comparability analysis of the controlled and uncontrolled transactions based on the comparability factors listed above.

This procedure will ensure that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transaction. And, this procedure will demonstrate that the analyst considered the nature of the transactions, as well as the factors and circumstances that

affect the price that would be paid—or the profit that would be earned—in the transactions.

ESTABLISHING THE ROYALTY RANGE

The Section 482 regulations allow an arm’s-length result to fall within a range. An analyst may develop a range of results by applying the same pricing method to as few as two uncontrolled transactions that have a similar level of comparability and reliability.

The arm’s-length price range consists of the results of all of the comparable uncontrolled transactions that meet the following conditions:

1. The information on the controlled transaction and the comparable uncontrolled transactions is sufficiently complete that it is likely that all material differences have been identified.
2. Each such difference has a definite and reasonably ascertainable effect on price or profit.
3. An adjustment is made to eliminate the effect of each such difference.

If there are no comparable uncontrolled transactions that meet these conditions, then the arm’s-length range may be derived from the results of all the comparable uncontrolled transactions that achieve a similar level of comparability and reliability.

If the taxpayer operating results fall within the arm’s-length price range, then no adjustment will be made to the taxpayer income or deductions.

That is, if the royalty rate charged by the taxpayer in the controlled transaction falls within the range of royalty rates derived from comparable uncontrolled transactions, then it will be considered to be an arm’s-length royalty rate result.

CONCLUSION

Trademarks, trade names, and brand names are valuable intangible property that are frequently transferred (or licensed) between related parties. Analysts are often tasked with estimating an arm’s-length royalty rate as part of a tax-related intercompany transfer pricing analysis.

Trademark royalty rates are typically one of the contested aspects involved in a transfer pricing dispute. Analysts often use the comparable uncontrolled transaction method when estimating trademark royalty rates for intercompany transfer price analyses.

Analysts should estimate intercompany transfer price trademark royalty rates using guidance from the Section 482 regulations. In order to establish credible and defensible trademark transfer price royalty rates, analysts should:

1. consider the comparability of market-based transactional evidence to the controlled transaction when selecting the transfer price method under the best method rule and
2. confirm that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transaction when using the comparable uncontrolled transaction method.

When trademark royalty rate CUT data are available, the CUT method may provide the most defensible and reliable indication of an arm’s-length royalty rate.

Notes:

1. Amazon.com, Inc. v. Commissioner, 148 T.C. No. 8 (2017).
2. Treas. Reg. §1.482-1(i)(4).
3. Treas. Reg. §1.482-4(d)(1).
4. Treas. Reg. §1.482-1(c)(1).
5. Amazon.com, Inc. 148 T.C. No. 8 at *32.
6. Treas. Reg. § 1.482-1(d)(2).
7. Amazon.com, Inc., 148 T.C. No. 8 at *27-29.



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